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CHAPTER II

PUBLIC EXPENDITURE

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CHAPTER II

PUBLIC EXPENDITUREI. The Law of Increasing Public Expenditure:-

The modern development of State expenditure continues to depend upon the extension of governmental activity. In all countries, even before the War, there was a gradual growth in the scale of public expenditure. The greatest increase in this expenditure took place in regard to the sums spent upon ~~armaments~~, both on land and on sea. This growth in the magnitude of public expenditure attracted attention to this important side of public finance which most writers on the subject had previously neglected. So long as public opinion held that the principal duty of government was the maintenance of law and order at home and the defence of the community from external aggression, then State expenditure was pushed down to an irreducible minimum. The view that national expenditure ought to increase in proportion to the spread of wealth was one that received but scant sympathy from orthodox Victorian finance. But the changing current of economic and social life brings new views on the functions of government. The modern State has to provide large sums annually for the education of its citizens, for social insurance of one kind and another, and for direct and indirect assistance to industry and trade. In view

In view of these ever-increasing and competing demands upon the public purse, a scientific examination of public expenditure has become an urgent necessity. When Gladstone said that "good finance consists more in the spending than in the collecting of revenue", he enunciated a truth which has too often been forgotten or ignored by modern statesmen with disastrous results.

The immense increase in public expenditure within recent times has led to the formulation of the law of increasing public expenditures by Prof. Adolf Wagner, one of the leading economists of modern Germany; and the law is thus translated by Prof. Ely:

"Comparisons between different countries and different periods show regularly among progressive nations an extension of public activities. This manifests itself extensively and intensively; the state and its subordinated political units continually undertake new functions, and they perform their duties, old and new, better and better.

In this way, that is through public agency, the needs of the population to an increasing extent, specially their common needs, are satisfied; and the public services for satisfaction of needs continually improve in quality. The clear proof of this is given statistically in the increased demands made by the states and the subordinate political units".

This tendency towards increasing public expenditures became remarkable in the period 1890-1914; and as already noted, the increasing public expenditures of most modern states were enormously increased during and after the last world-war.

II. Classification of Public Expenditure - The Various Methods:

(A) Classification According to Benefit Received - Plehn.

1. Those items of expenditure which confer a common benefit on all citizens. For example, defence, public health services.

2. Those which confer special benefit on certain classes, but which should be treated as a common benefit because of the incapacity of these classes. For example, poor relief.

3. Those which confer both a special benefit on certain persons and a common benefit on all the others. For example administration of justice.

4. Those which confer only a special benefit on individuals. For example State industries, subsidies, etc.

(B) Classification According to Revenue Received:-

1. Expenditure without any direct return by way of revenue. For example poor relief, pensions.

2. Expenditure without direct return, but with indirect benefit to the revenue. For example education, it being supposed that the educated are better taxpayers.

3. Expenditure with partially direct return. For example education for which fees are received, or subsidized railways which meet part of the expense.

4. Expenditure that obtains a full return, or, in extreme cases, yields a profit in addition, for example, the Post Office, gasworks, and State industries generally.

(C) Classification According to the Functions of Government - Adams:-

1. Protective Functions:

- i) Military.
- ii) Police and Court.
- iii) Social Diseases (prisons, asylums, pauperism, sanitation, etc.)

2) Commercial Functions:

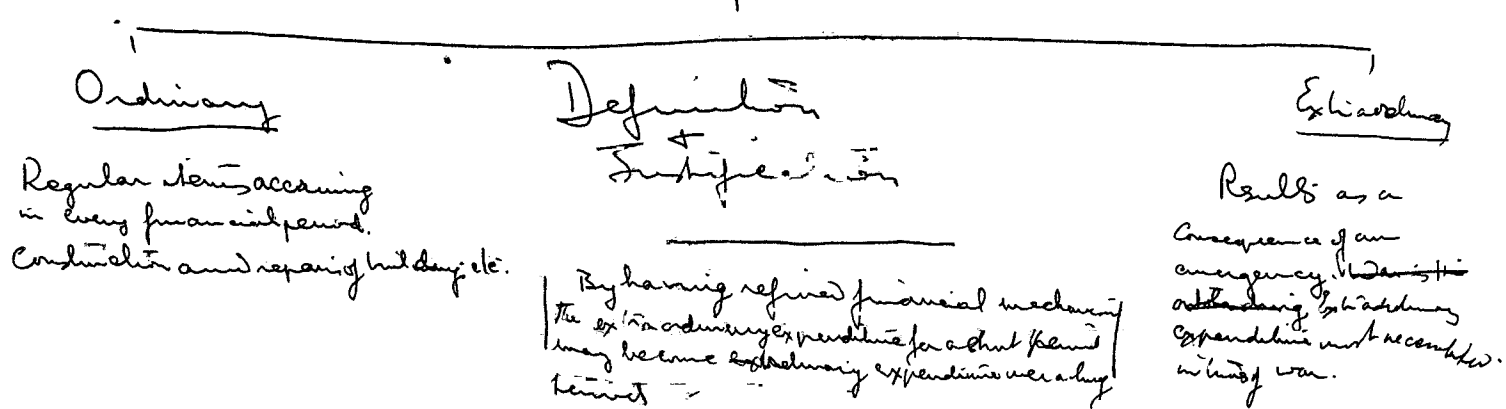
- i) Fiscal monopolies.
- ii) Postal system.
- iii) State railways and shipping.

3) Developmental Functions:

- i) Education.
- ii) Public recreation.
- iii) Prosecution of private business.
- iv) Public investigation. For example election of social statistics.

Ordinary and Extraordinary Expenditure

Government Expenditure



How met

Current receipts
e.g. taxes & duties
Covered out of ordinary revenue.

Practical expediency plays a great part in settling the question.

Rise of Public works
e.g. roads, some other things
cannot be covered by ord. revenue so
loans

Extraordinary expenditure justified by loans to some extent.

1) Emergency Finance:- War - is uncertain

Modern warfare - McCulloch's statement - We have to determine how much to be raised by interest and much of loans - Reliance on taxation would avoid some of the inflation & high prices which comes with almost inevitable prices when undertaken in a large scale - Rebuilding of devastated areas justifies ext. expenditure.

2). Permanent Productive enterprises:- Rygs, irrigation etc. - Time required to bear fruit - In commercial enterprises it is necessary to justify govt. participation.

3). Temporary Deficit:- Maybe necessary at times, must be used with caution - or else it will become a disease - Taxation continuous recurrence. Tax & duty must be...

- v) The development of the physical basis of the State. For example public works, docks, etc.

(D) Classification according to Functions of Government - Findlay Shirras:-

1. Primary Expenditure:

- i) Defence.
- ii) Law and Order.
- iii) Civil administration.
- iv) Debt services.

2. Secondary Expenditure:

- i) Social. For example, Education, Public health, Poor relief.
- ii) Public Undertakings. For example, Railways, Irrigation, Canals, Roads, Post offices, Waterworks.
- iii) Miscellaneous. For example Pension charges, Drawbacks.

III. Ordinary and Extraordinary Expenditure:-

Government expenditure may again be considered under the headings - ordinary and extraordinary expenditure. Although these two terms are self-explanatory, there arises, in practice considerable difficulties in assigning given items of expenditure to the appropriate class. The ordinary expenditure covers the regular items accruing in every financial period, the total of which remains steady or is subject to a known rate of change. Under the same heading, too, are included

provisions for such expenditure as the construction and repair of public buildings, which occurs only occasionally, but which can be predicted with reasonable certainty from past experience. Extraordinary expenditure, on the other hand, is that which occurs as a result of some particular emergency or unexpected event, so that it cannot be allowed for with any approach of accuracy. The most frequent type of extraordinary expenditure is that incurred in time of war.

Yet, as Bastable pointed out, the distinction is a vague one and tends to pass away as national budgets grow larger and financial estimates more accurate.

When the outlay is measured by thousands a variation in hundreds is serious; but when it reaches millions, changes of thousands are trifling, besides being balanced through savings in some other parts of expenditure. There is also in modern states a greater facility for foreseeing, and, so to say, "discounting" the future. The refined ^{By having refined} financial mechanism by which public borrowing is carried out enables "extraordinary" expenditure for a short period to ^{can be} transformed into 'ordinary' expenditure for a long one.

This distinction between ordinary and extraordinary expenditure assumes the greatest importance when we are faced with the problem of arriving at a decision as to how

it shall be met. It is usually held that the ^{ordinary expenditure} former should be met from current receipts, that is, from taxation and other current resources, whereas the latter should be met by the use of public credit ^(loans) or some similar device.

Here the principle which is to be followed is made quite clear - ordinary expenditure must be reduced to such limits that it can be covered by current revenue, and only unavoidable extraordinary expenditure be met out of loans. The great difficulty again arises in assigning given items of expenditure to one or other of these classes. In dealing with the whole question it is fairly evident that practical expediency will always play a large part. After the burden of taxation has reached a certain level, the Government will often tend to resort to borrowing if a loan can possibly be floated.

We may reduce the number of cases where extraordinary expenditure can be met by borrowing to three, namely -

1) Emergency Finance:-

It is permissible to use loans in financing an emergency, the cost of which is so great that taxation alone will not suffice. Of such emergencies, war is the chief, and is the most difficult to finance, since its duration, cost, and extent are uncertain. Modern warfare makes tremendous demands upon the resources of a nation, and the

scale of expenditure is such that it cannot be supported by taxation alone. In justifying borrowing for this purpose, McCulloch goes so far as to say, "No sacrifices can be too great that are required to preserve national security and independence, and a loan expended on armies and fleets employed for such a purpose is quite as well and profitably employed as if it had been laid out on agriculture or in promoting manufactures or trade". This statement is so extreme that it defeats its own purpose, but nevertheless in times of war the fate of future generations is equally at stake, so that on this ground it is only fair that they should bear some part of the burden. *(Stephen & Brink)*

In adopting this attitude we have next to determine what proportion of the expenditure shall be passed on to future generations - in other words, what proportion shall be financed by loans and how much by current taxation. Usually it will be found that, upon the outbreak of war, funds must be borrowed in order to cope with the immediate jump in expenditure. Later, as the machinery of taxation can be speeded up, expenditure out of revenue should increase to cover both interest charges and also as high a proportion of current expenditure as possible.

Again, reliance on taxation would avoid some of the inflation and high prices which loans almost inevitably produce when undertaken on a large scale. A policy of taxation in addition, lightens the post-war problem of debt payment,

and avoids the long period of heavy taxation to meet the debt charges.

We may include under this heading the extraordinary expenditure which is necessitated in the work of post-war reconstruction in devastated areas, where reconstruction charges cannot possibly be met from ordinary receipts. The restoration of such regions is of primary importance for the re-establishment of normal economic conditions, so that loans for this purpose have every justification.

2) Permanent Productive Enterprises:-

A State may borrow money in order to meet the capital expenditure involved in the construction of productive undertakings, such as railways, irrigation works, and electricity undertakings. In the case of public undertakings of these types, it is obviously unfair to ask the taxpayers during a single year to bear the entire burden, when the benefits are going to be received over a long period of years. On the other hand, of course, in the case of commercial enterprises undertaken by the Government, it is necessary to justify Government participation. An industry may sometimes be publicly owned and managed because it is necessary in the interests of public, but private enterprise is incapable of providing the required capital, or is unwilling to assume the risks involved. Thus in many countries the State ownership of railways was occasioned by these factors.

When, however, we enter the field of activity which is, or has been left to private enterprise, then we find ourselves in a sphere of bitter controversy. To what extent is the State justified in entering into competition with its own citizens, or of taking over by compulsion their business and operating them itself? We can only reply in general terms and say that public interest may warrant such a course, and that each case must be taken on its own merits. ^{Says} ~~Says~~ Sir Arthur Salter, ^{Says} "The fact is that the suitability of an enterprise for State control varies greatly according to its character. Where its development has already resulted in a practical monopoly, so that the public get the benefit neither of competitive prices nor of controlled profits; where such competition as remains takes the form of attracting the consumer by advertisement, costly shops, appeals of agents on commission, and not of reduction of price or improvement of quality; and where hazardous experiment is not greatly needed; there is a prima facie case for the State. The case is proportionately weaker as far as these conditions do not apply".

In order that the expenditure of public money may be justified there must be strong reasons for the interposition of the State in industrial enterprises. The State should be in a position to operate them at least as efficiently as the private entrepreneur, and secure a greater freedom

from any abuses to which they may have been subjected - and in these respects the past history of State-owned enterprises is none too reassuring. The taxpayer may ultimately be called upon to make good a deficit on the operation of public enterprises, and where this occurs it should be possible to point to some compensating advantage. Where a case can be established for State enterprises, then there is considerable justification for providing the original capital expenditure from borrowed funds.

3) Temporary Deficit:-

In case of necessity, in order to cover a temporary deficit, recourse may be had to borrowing. In the modern State, with its tremendous expenditure, it is quite impossible always to forecast accurately the amount that will be required during a fiscal period, or to gauge the yield of the many sources of revenue. The only way in which to ensure that revenue would always exceed expenditure would be to budget for a fairly large surplus, and this, apart from the resentment which it would be likely to arouse in the taxpayer, is apt to encourage extravagance. The employment of borrowing for this purpose is a power which cannot be used with too much caution. To meet a series of deficits by borrowing money to bridge the gap is simply to court disaster sooner or later. Borrowing may be permissible to meet an occasional deficit, but if the shortage becomes habitual, then more revenue must be obtained.

✓ **IV. Canons of Public Expenditure:-**

✓ In so far as the Government is employing resources which have been contributed mainly by the citizens through taxation, it will be evident that State expenditure should be governed by rigid principles. Sir Ernest Benn, has recently propounded three tests, to be applied to every form of public activity, whether national or municipal. "First: Is the work worth doing? If the need for it real? Second: Is there no other way of achieving the same object, no cheaper or more efficient or more reliable agency through which it can be secured? Third: Have we the money to pay for it?" The third test is, of course, decisive, since no matter how desirable certain expenditure may be, if the community cannot afford to pay for it they must go without." (

✓ Where expenditure is undertaken, the following principles should be observed:-

1) Canon of Benefit:-

The expenditure of the State should be so directed as to confer increased social advantages upon the community as a whole. Indeed, it has been said that the State should expand its expenditure so long as there is a greater social gain to be derived from the public use of the money that is spent than would have been derived from the private use to which this money would otherwise have been devoted. This version of the principle may be un-

unobjectionable in theory, but its realization is out of the question in practice. The public revenues are unfortunately not invariably derived from those resources which are employed in the least productive manner in the hands of private individuals.

Another factor which must be kept in mind is the distribution of expenditure. The balance should be held fairly between one object and another, so that one sphere of public activity is prevented from developing at the expense of another.

Says Nicholson, "The ideal of public expenditure on the utilitarian principle would be attained when the public utility of the marginal expenditure in each case is equal. The idea is no doubt unattainable, but it is not unthinkable, and the pursuit of it may lead to important practical results. Without a beacon of this kind expenditure may be continued in certain directions long after it is justified by changing conditions, and the most necessary reforms may be met with the non possumus of passive inertia." ¹ (S+B)

2) Canon of Economy:-

1) The second principle which must be observed is that, in handling public money, at least as much care should be exercised as in spending private income. A scrupulous adherence to this principle is essential if the level of taxation is to be kept at the lowest limit, and in

any case, no matter what the burden of taxation may be, the wasting of public funds can never be justified.

3) Canon of Sanction:-

" This is the principle that no public expenditure should be incurred without proper authority being received. Thus, in Great Britain, no money can be raised by taxation and none can be spent except under the authority of Parliament. Furthermore, no money can be spent save for the purpose to which Parliament has appropriated it. The Treasury is given power to make issues out of the Consolidated Fund into which the proceeds of all taxation are paid. The Treasury, in its turn, must satisfy the Comptroller and Auditor-General that the requisition is in accordance with the Acts which govern the proposed expenditure. " (Sd B.

4) Canon of Surplus:-

Governments, in the same way as private individuals, should endeavour by every means within their power to keep expenditure within the limits set by current revenue. In other word, financiers should avoid deficits whenever possible. This does not imply, of course, that the accumulation of a large surplus should be the aim and object of public finance for, as already pointed out, this may result in waste. The aim should be to balance revenue and expenditure as closely as possible. (Sd B. [signature])

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V. Economic Effects of Public Expenditure:-

As we have already seen in dealing with the Bank of England and the money market, the financial operations of the Government are capable of exerting a big influence upon financial institutions. But the economic effects of public finance are obviously more far-reaching than this, and affect either directly or indirectly all individuals and institutions within the community. The government, through its system of taxation and expenditure, is responsible for the transference of large amounts of wealth from one employment to another, and this redistribution is bound to have effects which cannot be ignored. Certain of these consequences are deliberately calculated by the Government; others merely occur as an indirect consequence of some other action.

Thus, State expenditure may be deliberately employed to stimulate certain branches of production, usually by providing bounties or subsidies from public funds. Such expenditure, of course, requires a very strong justification, since it involves the employment of public funds for the benefit of sectional interests and may easily cause an undesirable competition on the part of other industries for assistance. Again, the State may, more legitimately, stimulate industries by making grants for research where private enterprise cannot undertake this unaided.

One of the most important questions of recent times has been the possibility of the Government planning its expenditure in such a way so as to influence industrial activity in general. It has been argued that, inasmuch as modern industrial activity appears to move in cycles of alternate boom and depression, these fluctuations might to some extent be counteracted by the action of the State and local authorities in adjusting their expenditure and concentrating it in those periods when private business was slack. This policy in connection with public works has two aspects, namely, on the one hand, to reserve for periods of unemployment work undertaken for public authorities, and on the other, to organize and create entirely new works in periods of depression in order to stimulate industrial activity.

State expenditure may affect distribution in different ways. :

The State may take money by taxation from the rich and give this money directly to the poor - thus is done practically under the Old Age Pensions scheme introduced in Britain in 1906 for granting pensions under certain conditions to the aged poor above the age of 70.

The State may raise money from the richer classes by means of a high rate of income-tax and high death-duties, and it may spend the money largely in educational and public health expenditure for the benefit of the poorer classes as

in Britain - this practically transfers some wealth from the rich to the poor, and thus distribution is affected by State Expenditure.

The modern tendency in all progressive states is to redress some part of the existing inequalities of wealth among the different classes by State Expenditure and also by the method of levying State Revenue.

The great danger of such attempted re-distribution is that it may check the production of wealth in the country

i) by reducing the productivity of the rich capitalists and employing classes

ii) by making the poorer classes too dependent on state help.

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